

Revisiting FinCEN's Virtual Currency and Prepaid Access Rules

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Revisiting Virtual Currency and Prepaid Access

Discussion of Convertible Virtual Currency under FinCEN's Rules

- Why does virtual currency fall under the money transmitter category (as opposed to prepaid access)?
- What are the ramifications of being classified as a money transmitter? What does this status implicate?
- What potential criminal liability does the classification provoke?

A "Look-back" at FinCEN's Prepaid Access Rule

- How have companies complied with the Rule?
- What have been the lessons learned?
- What is the impact of the Rule on innovative payment products and systems?

Redefining MSBs

Tracking the evolution of new payments methods and setting the stage for more comprehensive and less ambiguous (at least theoretically) regulation, FinCEN, in July 2011, published its Final Rule amending the definition of money services businesses (or “MSBs”) and other regulations relating to MSBs.

The Final Rule amended the definitions of MSBs, specifically dealers in foreign exchange (formerly referred to as “currency dealers and exchangers”) and money transmitters.

Redefining MSBs

An MSB was specifically redefined by FinCEN in the amended regulations as “a person wherever located doing business, whether or not on a regular basis or as an organized or licensed business concern, wholly or in substantial part within the United States, in one or more of the [following capacities]”:

- (i) dealer in foreign exchange;
- (ii) check casher;
- (iii) issuer or seller of traveler’s checks or money orders;
- (iv) U.S. Postal Service;
- (v) money transmitter;
- (vi) provider of prepaid access and
- (vii) **seller of prepaid access.**

Redefining MSBs

FinCEN also redefined the term “money transmitter” to include a person that provides money transmission services, or any other person engaged in the transfer of funds. The term “money transmission” was redefined as “the acceptance of currency, funds, or other value that substitutes for currency from one person *and* the transmission of currency, funds, or other value that substitutes for currency to another location or person by any means.”

Intersection of Prepaid Access and Virtual Currency

On July 29, 2011, FinCEN published its Prepaid Access Rule. Highlights of the Prepaid Access Rule include the following:

- The definition of prepaid access was confined to *real* currency, thereby excluding its application to *virtual* currencies.
- It is important to note, however, that the framework provided under the Prepaid Access Rule has been relied upon by FinCEN in its guidance relating to virtual currencies. Although definitionally different, prepaid access and virtual currency are therefore interconnected as “weaved” together by FinCEN.

FinCEN's Virtual Currency Guidance

With respect to virtual currencies, FinCEN first issued interpretive guidance in March 2013 to clarify the applicability of the BSA's implementing regulations to persons who "use," "administer," or "exchange" virtual currencies.

The guidance addresses "convertible" virtual currency, defined as a type of virtual currency that either has an equivalent value in real currency or acts as a substitute for real currency.

The guidance specifically sought to clarify which participants in generic virtual currency arrangements --- users, administrators or exchangers --- would be considered money transmitters, and thus categorized as MSBs, subject to the BSA and under FinCEN's purview.

FinCEN's Virtual Currency Guidance

The Guidance distinguishes the three participant types who engage in virtual currency transactions.

- A “**user**” is a person who obtains virtual currency to purchase goods and services.
- An “**administrator**” is a person engaged as a business in issuing (i.e., putting into circulation) a virtual currency, and who has the authority to redeem (i.e., to withdraw from circulation) such virtual currency.
- An “**exchanger**” is a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency.

Critical Distinctions: Under the Guidance, **users** are not money transmitters, while both **administrators** and **exchangers** are. As money transmitters, they are MSBs within the full ambit of the BSA.

Additional FinCEN Virtual Currency Guidance

On January 30, 2014, FinCEN issued two administrative rulings addressing the application of the BSA to certain convertible virtual currency transactions.

The first ruling related to Bitcoin “miners.” Specifically, FinCEN was asked whether certain ways of disposing of Bitcoins would cause the company to fall within its money transmitter MSB status rules. FinCEN articulated that, to the extent that a user mines Bitcoin and uses the Bitcoin solely for the user’s own purposes and not for the benefit of another, the user is **not** an MSB. These activities involve neither “acceptance” nor “transmission” of the convertible virtual currency and are not the customary transmission of funds sought to be covered under the rules.

Additional FinCEN Virtual Currency Guidance

This is the case whether the user mining and using the Bitcoin is an individual or a corporation, and whether the user is purchasing goods or services for the user's own use, paying debts previously incurred in the ordinary course of business, or (in the case of a corporate user) making distributions to shareholders. Activities that, in and of themselves, do not constitute accepting and transmitting currency, funds or the value of funds, are activities that do not fit within the definition of "money transmission services."

Additional FinCEN Virtual Currency Guidance

FinCEN, in reaching its conclusions, further provided that money transmission would not include the following: “(a) to pay for the purchase of goods or services, pay debts it has previously incurred (including debts to its owner(s)), or make distributions to owners; or (b) to purchase real currency or another convertible virtual currency, so long as the real currency or other convertible virtual currency is used solely in order to make payments (as set forth above) or for the company’s own investment purposes.”

FinCEN did admonish, however, that “any transfers to third parties at the behest of sellers, creditors, owners, or counterparties involved in these transactions should be closely scrutinized, as they may constitute money transmission.”

Additional FinCEN Virtual Currency Guidance

On January 30, 2014, FinCEN issued two more administrative rulings addressing the application of the BSA to certain convertible virtual currency transactions.

The first ruling related to Bitcoin “miners.” Specifically, FinCEN concluded that, so long as a person creates or “mines” a convertible virtual currency ***solely for their own benefit, and not for the benefit of another***, then that person would not be considered a money transmitter, and thus not subject to regulation under the BSA.

Additional FinCEN Virtual Currency Guidance

FinCEN, in the second administrative ruling, reviewed the applicability of the BSA to *software_development* relating to virtual currencies.

Specifically, FinCEN considered whether the rental of computer systems for mining virtual currency would make the Company an administrator of virtual currency and thus a money transmitter under the BSA.

Additional FinCEN Virtual Currency Guidance

Facts: The requesting Company developed a computer system that mines crypto currencies; and, at times, rented its system to third parties in exchange for a payment based on the rental period. The rental period could toll from 24 hours to 30 days. In using the system, the renting third party would furnish the Company with limited information about its mining pool, which the Company would enter into the system so the third party benefits directly and exclusively from the mining work. All virtual currency mined by the third party would remain the third party's property, with the Company having no access to the third party's wallet, nor receiving or paying virtual currency on the third party's behalf.

Additional FinCEN Virtual Currency Guidance

FinCEN concluded that the rental of computer systems to third parties is not an activity covered by FinCEN regulations, which specifically exempt from money transmitter status a person that only provides the delivery, communication, or network data access services used by a money transmitter to supply money transmission services. So, even if the Company rents a computer system to third parties that will use it to obtain convertible virtual currency to fund their activities as exchangers, this rental activity, in and of itself, would not make the Company a money transmitter subject to BSA regulation. What was absent here was the ***acceptance and transmission*** of value. Simply, there was no transfer of value from the Company to its third party customers.

Additional FinCEN Virtual Currency Guidance

In guidance tendered in October 2014, FinCEN, based on the facts and circumstances presented, determined in two rulings, one involving a virtual currency trading platform and the other a virtual currency payment system would cause the petitioning companies to become money transmitters.

Facts for Virtual Currency Trading Platform: The petitioning company planned to establish a platform that consists of a trading system (System) to match offers to buy and sell convertible virtual currency for real currency, and a set of book accounts in which prospective buyers or sellers of one type of currency or the other (Customers) can deposit funds to cover their exchanges.

Additional FinCEN Virtual Currency Guidance

Facts: The company will maintain the funding received from each Customer in its separate book entry account (Customer Account). Once the exchange is funded, the Customer will submit an order to the company to purchase or sell the currency deposited at a given price. The Platform will automatically attempt to match each purchase order of one currency to one or more sell orders of the same currency. If a match is found, the company will purchase from the Customer/seller and sell to the Customer/buyer, without identifying one to the other. If no match is found, the Customer may elect to withdraw the funds or keep them in its Customer Account to fund future orders.

Additional FinCEN Virtual Currency Guidance

Facts: The company, in addition, will not allow inter-account transfers, third-party funding of a Customer Account, or payments from one Customer Account to a third party. The company claimed that payments to or from its Customers are sent or received by credit transmittals of funds through ACH or wire transfers from U.S. banks. The Platform will not allow any Customer to know the identity of another Customer, and Customers must conduct transactions exclusively through their formal agreements with the company.

Additional FinCEN Virtual Currency Guidance

Facts: Further, the company will maintain separate accounts in U.S. dollars and a virtual wallet, both segregated from the company's operational accounts and protected from seizure by the company's creditors (Funding Accounts), in which its Customers will deposit their U.S. dollars or convertible virtual currency to fund the exchanges. The company will maintain the funding received from each Customer in its separate book entry account (Customer Account).

Additional FinCEN Virtual Currency Guidance

Facts: Most notably, the company was already registered with FinCEN as a money transmitter and as a dealer in foreign exchange. The company further argued that it should not be regulated as a money transmitter because it acts in a manner similar to securities or commodities exchanges, and there is no money transmission between the company and any counterparty. Alternatively, the company argued that its activities should not be deemed as money transmission because it should be subject to either the payment processor or integral exemptions (discussed later) or that it should fit within the definition of “user” rather than “exchanger” or “administrator” under FinCEN’s guidance.

Additional FinCEN Virtual Currency Guidance

Analysis: FinCEN disagreed with the company's basic contention that there is no money transmission when the instructions of the customers are issued subject to the condition of finding an offsetting match. FinCEN argued that the regulatory definition of money transmission does not contain any element of conditionality before it applies: "A person that accepts currency, funds, or any value that substitutes for currency, with the intent and/or effect of transmitting currency, funds, or any value that substitutes for currency to another person or location if a certain predetermined condition established by the transmitter is met, is a money transmitter under FinCEN's regulations."

Additional FinCEN Virtual Currency Guidance

Analysis: Specifically, FinCEN found that in each trade conducted through the Platform, two money transmission transactions occurred: one between the company and the Customer wishing to buy virtual currency, and another between the company and the Customer wishing to sell such virtual currency at the same exchange rate. view, the payment service that the Company intends to offer meets the definition of money transmission. FinCEN viewed the company's activities as facilitating the transfer of value, both real and virtual, between third parties, declaring the activities as the sole purpose of the company's System.

Additional FinCEN Virtual Currency Guidance

Analysis: FinCEN also discredited the company's position that it should be considered a user and not an exchanger, because "a true virtual currency exchange would have its own reserve of virtual currency and dollars that it would buy and sell in order to fund exchanges with its users." FinCEN contended that a person is an exchanger and a money transmitter if the person accepts convertible virtual currency from one person and transmits it to another person as part of the acceptance and transfer of currency, funds, or other value that substitutes for currency. FinCEN found that the method of funding the transactions was not relevant to the definition of money transmitter.

Additional FinCEN Virtual Currency Guidance

Analysis: FinCEN determined that the company's MSB status was that of an exchanger of convertible virtual currency, subject to the same obligations under FinCEN regulations regardless of whether the exchanger acts as a broker (attempting to match two (mostly) simultaneous and offsetting transactions involving the acceptance of one type of currency and the transmission of another) or as a dealer (transacting from its own reserve in either convertible virtual currency or real currency).

Open Issue: Would FinCEN still maintain this position now that the SEC has determined that some aspects of virtual currency resemble that of a security?

Additional FinCEN Virtual Currency Guidance

Facts for Virtual Currency Payments Scheme: The petitioning company wanted to establish a system that would provide virtual currency-based payments to merchants in the United States and Latin America (mostly) who wished to receive payments for goods and services sold in a currency other than that of legal tender in their respective jurisdictions.

Additional FinCEN Virtual Currency Guidance

Facts: The Company would receive credit card payments from participating buyers or debtors (rather than the merchant) in real (i.e., fiat) currency and then “transfer” (or pay the merchant) the equivalent from its Bitcoin reserves, which it has received from wholesalers, to the seller or creditor, decremented by a transaction fee. In fact, the Company would function as an exchanger/ broker by “matching two (mostly) simultaneous and offsetting transactions involving the acceptance of one type of currency and the transmission of another) or as a dealer (transacting from its own reserve in either convertible virtual currency or real currency).”

Additional FinCEN Virtual Currency Guidance

Analysis: FinCEN concluded that the Company was a money transmitter because it functioned as an exchanger of convertible virtual currency. FinCEN further concluded that “[t]he fact that the Company uses its cache of Bitcoin to pay the merchant is not relevant to whether it fits within the definition of money transmitter.”

Key Takeaways: FinCEN articulated two exemptions:

- (i) Payment processor; and
- (ii) Integral (i.e., to the provision of goods or services).

Discussion of the Payment Processor Exemption

FinCEN has articulated four conditions that have to be satisfied to trigger the availability of the payment processor exemption:

(i) the entity providing the service must facilitate the purchase of goods or services, or the payment of bills for goods or services (other than the money transmission itself);

(ii) the entity must operate through clearance and settlement systems that admit only BSA-regulated financial systems (such as a credit card network);

(iii) the entity must provide the service under a formal agreement; ***and***

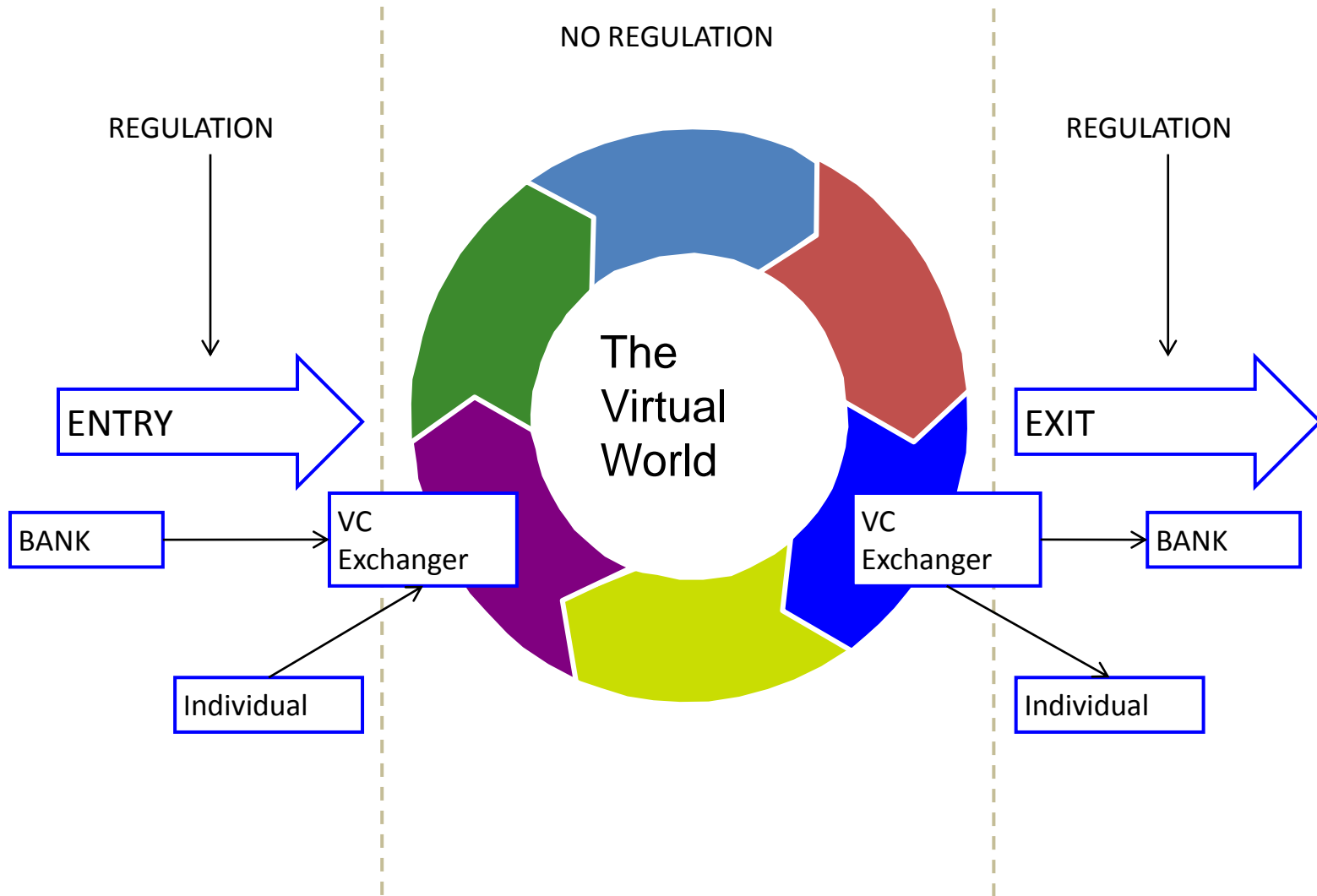
(iv) the entity's agreement must be, at a minimum, with the seller or creditor that provided the goods and services and receives the funds.

Discussion of the Integral Exemption

In determining whether this exemption applies, FinCEN has to conclude that the money transmission is **integral** to the provision of an entity's goods or service. FinCEN stipulates that a three-pronged test that must be satisfied for the exemption to attach:

- (i) The money transmission aspect of the transaction must be part of the provision of goods and services separate from the money transmission itself;
- (ii) The exemption can only be claimed by the person that engaged in the provision of goods or services distinct from the money transmission; and
- (iii) The money transmission component must be integral (i.e., essential) to the provision of goods and services.

Virtual Currency- Parameters of Regulation



QUESTIONS???

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